DOW THEORY LETTERS INC.

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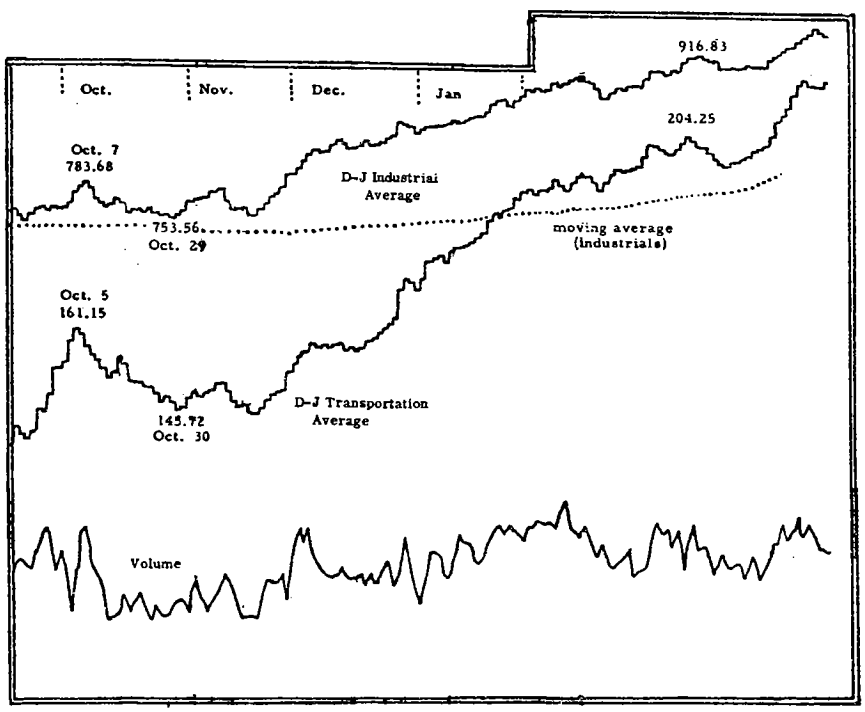
THE MARKET: April 15: The Transportation Average set a recovery high of 219.24. April 19: The Industrial Average struck a recovery high of 948.85. The picture for the optimists is easy enough. If the two Averages better those two marks, the recovery is still in force.

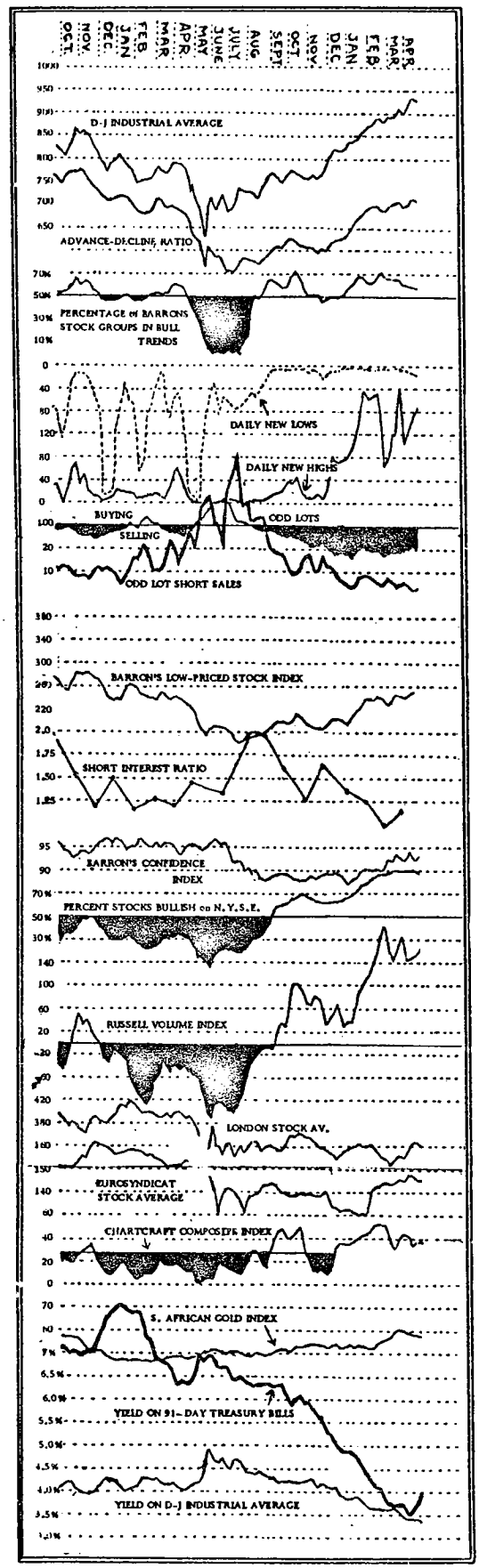
From the standpoints of those solitary bears who believe that this is a huge rally in a continuing primary bear market, the picture is somewhat different. Perpendicular rallies in primary bear markets (see next section) tend to "turn on a dime, then crumble, leaving stockholders looking up at where their stocks were", and then looking down at where their stocks seem to be heading .

Bear market rallies expire when the upward momentum runs out. If any upward momentum is running out now, it is in the majority of issues as reflected in the advance-decline ratio. A later section of this Letter covers this phenomenon. It should be noted, however, that since the mid-February minor Dow peak of 890.06, the A-D ratio has been sluggish, gaining less than a point while the Industrials gained 58 points. Thus, while the upside action has been desultory in the main mass of stocks on the N.Y.S.E., it has been the Dow which has been putting on the show. We will shortly see whether "the show must go on".

SPIKE: The accompanying chart on page 2 (courtesy of Securities Research, 208 Newbury St., Boston, Mass. 02116) spans the period from 1914 to the present. Study all the advances starting with the beginning of the chart. Note the angle of ascent on each, from 1926-29 to 1957-59 and 1962-66.

One comes to the following observation: The current 1970-71 rise is the greatest "spike" upmove in history. The rising angle, as shown on this arithmetic chart, is almost perpendicular. Note what happened after each of

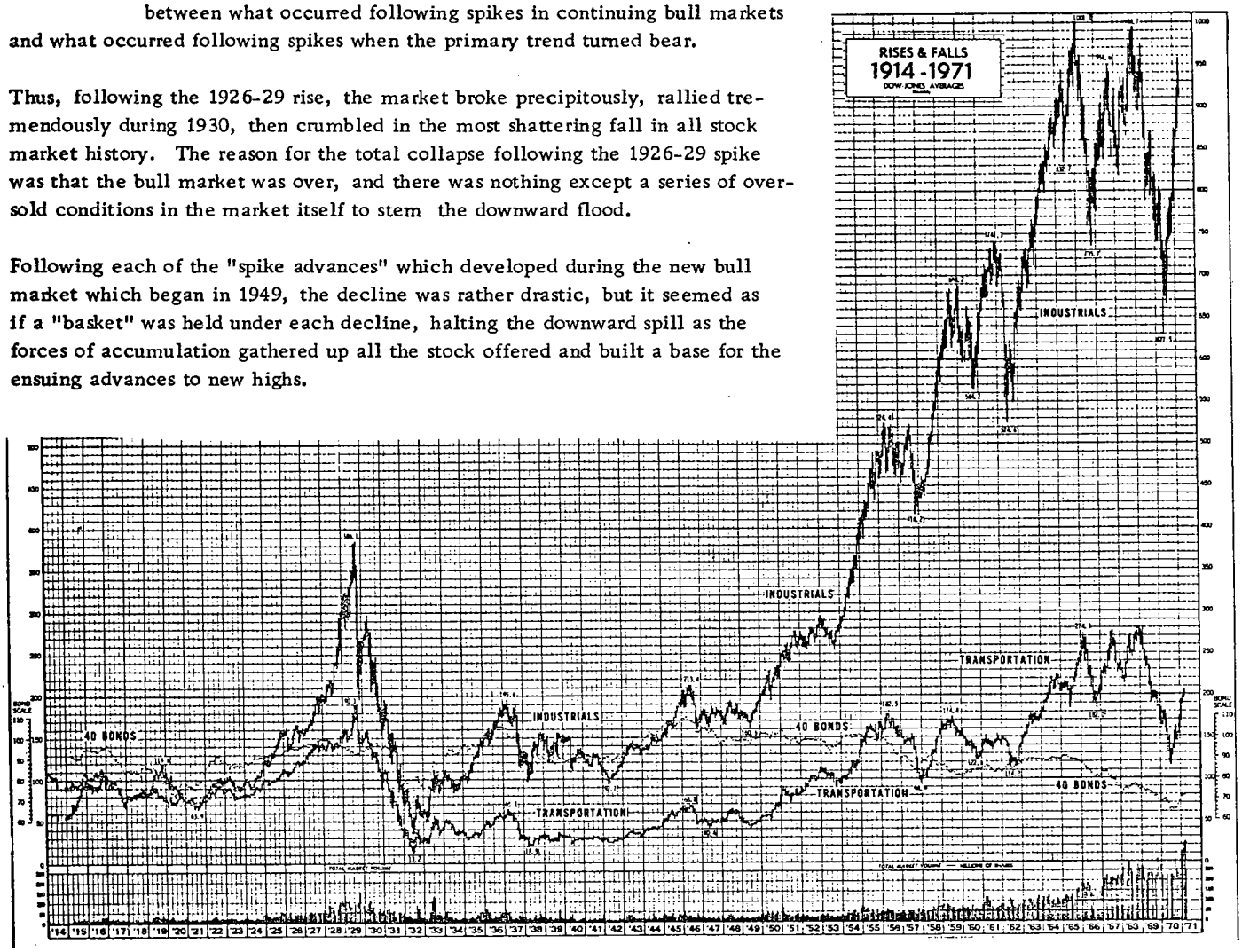




the previous spikes topped out. There is a major difference between what occurred following spikes in continuing bull markets and what occurred following spikes when the primary trend turned bear.

Thus, following the 1926-29 rise, the market broke precipitously, rallied tremendously during 1930, then crumbled in the most shattering fall in all stock market history. The reason for the total collapse following the 1926-29 spike was that the bull market was over, and there was nothing except a series of oversold conditions in the market itself to stem the downward flood.

Following each of the "spike advances" which developed during the new bull market which began in 1949, the decline was rather drastic, but it seemed as if a "basket" was held under each decline, halting the downward spill as the forces of accumulation gathered up all the stock offered and built a base for the ensuing advances to new highs.



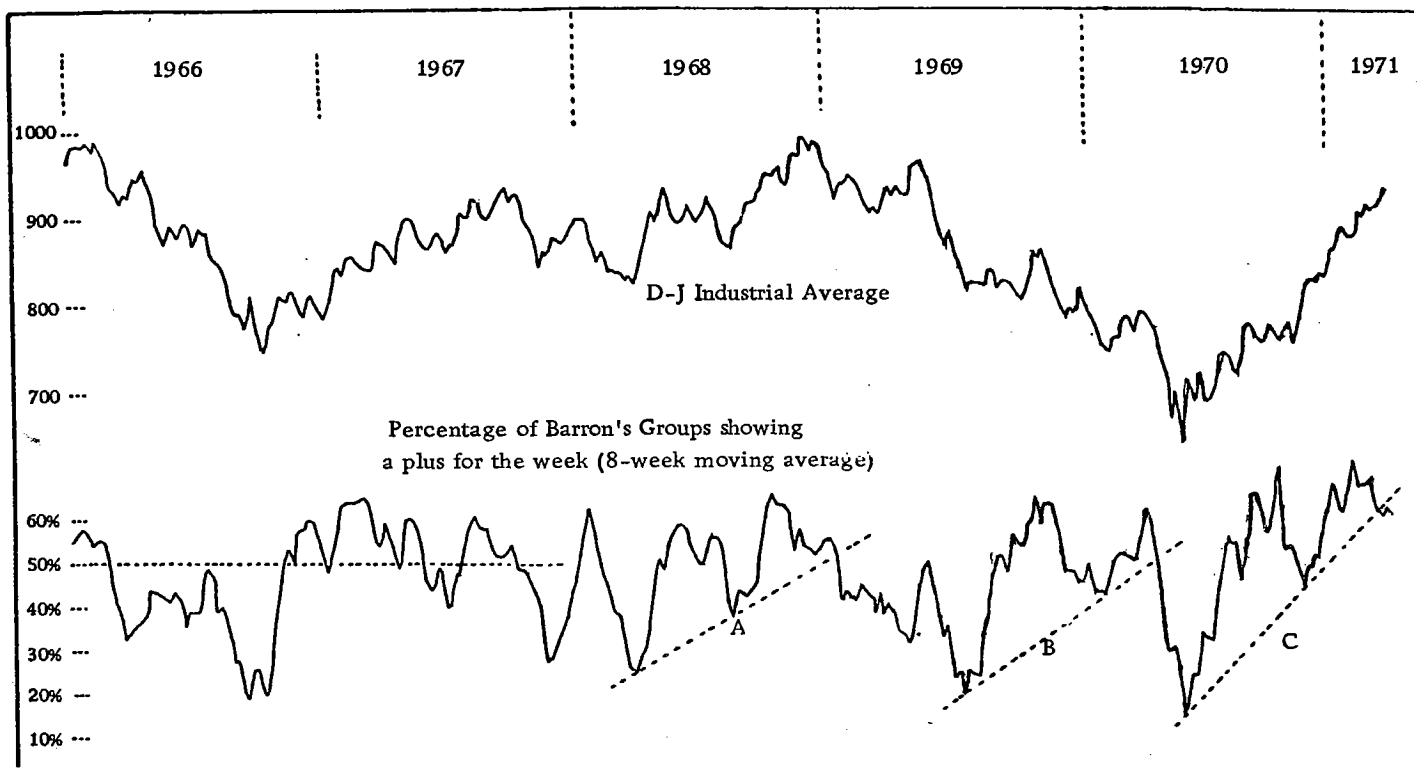
In February, 1966, according to my studies, the primary bull market which began in 1949, topped out. A most extraordinary primary bear market started. The first plunge took the Dow from its bull market peak of 995 to an October, 1966 low of 744. The recovery which followed failed for the first time since 1949 to better the previous (995) peak (see chart). Again the Dow plunged and whereas the first (1966) plunge was 251 points, the second plunge wiped out 355 points, taking the Dow to the 1970 low of 631. As noted in these Letters at the time, the area around the lows of 631 saw the worst breadth collapse (i.e., A-D ratio) in market annals. This extraordinary compression was followed by the almost perpendicular rise of 1970-71.

It is interesting to note that spearpoint peaks have characterized the major turns (following spike run-ups) during bear markets. In 1929 after the tide turned bearish, we get a picture of an acute spearpoint top. This was not true of the reversals which followed until we come to the primary reversal in 1966. Here we see what appears to be a spearpoint top. With the primary bear market continuing, the typical spearpoint formation appeared again at the late-1968 top.

The question is — what will happen when the current "straight-up" spike formation runs out of steam, and the forces of the primary bear market suddenly come into play? I would think that because of the extreme rising angle of the current formation, and because this run-up occurred during a bear market which is already five years old, the reversal will be perhaps the sharpest spearpoint top on record.

As a rule, the sharper the rise the more violent the decline. This is true even during bull markets. But what the current rise will bring when this continuing bear market again takes hold I cannot imagine. There have been no reactions and no real consolidations in the rise since November 1970. This leads me to believe that the crack-up, when it comes, could easily be one of the worst, if not the worse, that has ever hit Wall Street. With funds dumping massive blocks in an attempt to grab profits, the decline could be of mammoth and unbelievable proportions.

GROUPS ADVANCING: One of the studies which I keep is based on the percentage of Barron's groups advancing. The accompanying chart traces this Index and the Dow going back to 1965. Each week Barron's publishes tabulations on 35 stock groups (including the three D-J stock Averages, which I include, although I delete the Gold Average, which tends to run counter-cyclical). Weekly I compute the percentage of the groups which advanced (i.e., those which registered a plus for the week). These weekly percentages of groups that advanced are then placed on an eight-week moving average. Thus, the Index is an eight-week moving average of the percentage of groups advancing.



I have followed my Index for seven years, and I like it because almost no one else follows it, and because it has given some good signals regarding the trend of the market. The Index seems to be more accurate regarding sell than buy signals, and in view of this it is worth studying now, particularly since it is now flying in the face of the broad bullishness regarding the stock market.

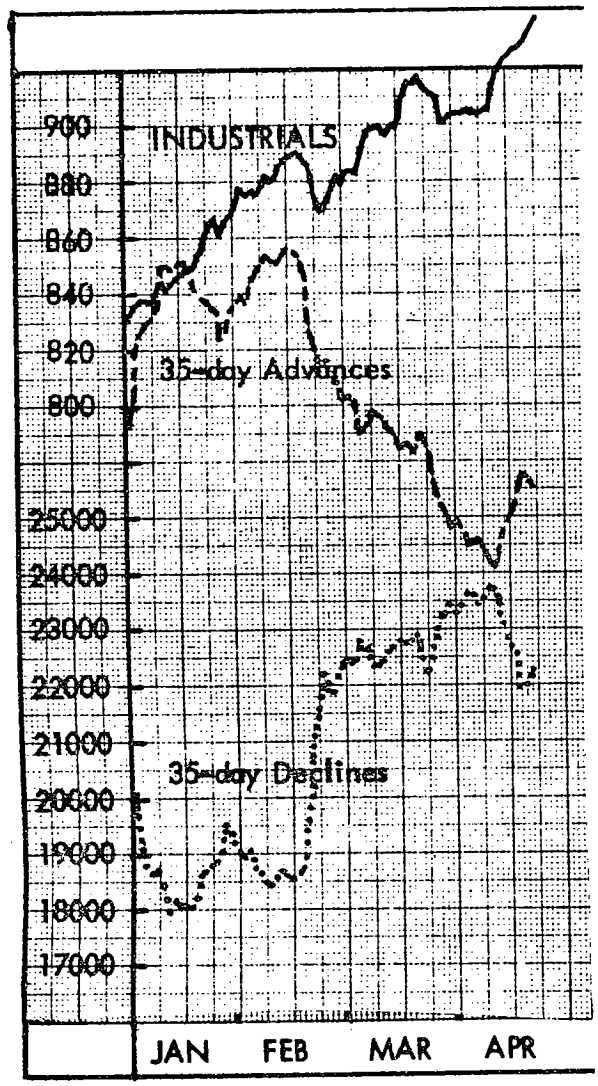
I "read" the groups advancing on a trendline basis. For a sell signal I require a major rising zig-zag, and then a rupture of the ascending trendline. Note that the first such signal came in January, 1969, when trendline "A" was broken. This proved to be a superb signal, catching almost all of the massive 1969-70 collapse. The second signal (when trendline "B" was broken) came towards early 1970, and this caught the final collapse into May of that year (Dow was 631).

Starting with May, 1970, a new rising zig-zag was formed, a zig-zag which recorded a peak (February 19) of 74%, slightly above the 73% of October 9, 1970. The trendline marked "C" was drawn through the 1970 lows of the Index. On the week of April 1, the Index dropped to 61% advancing. In so doing, it broke trendline "C".

The breaking of trendline "C" constitutes a sell signal on the groups advancing Index. The Index is now (61%) at its lowest level since December 24, 1970. Obviously, no one can guarantee what will happen, but it should be noted that the Index has broken (on a trendline basis) the momentum of the entire advance since May, 1970. This constitutes the first sell signal rendered by the Index since March, 1970.

It should be remembered that this Index has nothing to do with the Averages or any overall index of the market. But since it reflects a break in the upward momentum of groups advancing, it should be reflected in the A-D ratio or the number of issues advancing or declining daily. Currently, we should see a tendency towards small pluralities of advances over declines on days when the Dow is rallying, and larger pluralities of declines over advances on days when the market declines. The second step should be a definite downturn in the A-D ratio, and the final step should be a reversal to the downside in the D-J Averages.

ISSUES ADVANCING: And speaking of the number of stocks advancing, here we see a decline in the number of stocks participating in the advance. The accompanying chart (courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62002) shows the Dow Industrials (daily) together with a 35-day moving average of daily advances and a 35-day total of daily declines.



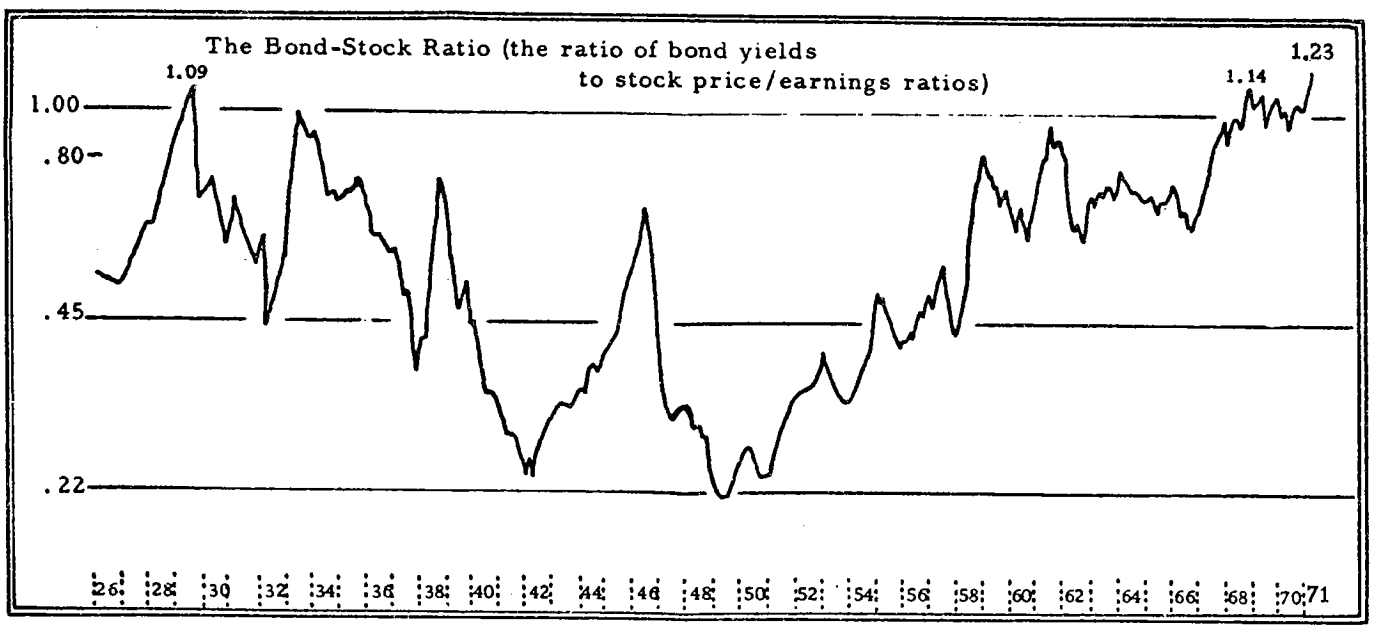
Since mid-February, the 35-day average of advances has been declining while the 35-day average of declines has generally been pushing higher. In a market where the Dow is advancing, I always pay particular attention to the 35-day average of advances (rather than declines). Note that there are fewer and fewer stocks on the N.Y.S.E. which have been following the Dow to new high recovery ground.

Classically, an advance terminates with a spurt in the Dow in which the rest of the market lags or refuses to participate. We could be entering that period as April runs out.

RECORD OVERVALUATION: Readers of these reports have been following the stock-bond ratio as published in Barron's weekly on the Market Laboratory page. The accompanying chart shows the stock-bond ratio going back to 1926 (original chart courtesy of Bank Credit Analyst of Montreal).

Broadly speaking (if we disregard the safety factor in each individual bond situation), bond values are based on yields. The higher a bond yields, the more it is worth. By the same token, broadly speaking stock values may be gauged on the basis of price/earnings ratios. For example, when GM is selling at 8 times earnings, it is a greater value than when it is selling at 12 times earnings.

The stock-bond ratio relates stock values to bond values. The ratio rises when the yield on bonds climbs (which occurs when the price of bonds declines). The ratio also rises when the P/E ratio of stocks advances (which occurs when the stock market is headed up). Either of those movements indicates a trend towards greater values in bonds as compared with stocks. The opposite is true when the stock-bond ratio declines (when that happens the trend of value is towards stocks as compared with bonds).



As seen on the chart, the stock-bond ratio has climbed over the rarefied 1.00 level only three times in history. In 1929 the ratio rose to a final peak of 1.09, and that proved to be an historic zone of overvaluation. The Great Crash followed, and during the long, dark period which ensued, the stock-bond ratio headed generally down (towards great stock values). The final low was recorded in 1949, when the stock-bond ratio sank below .20.

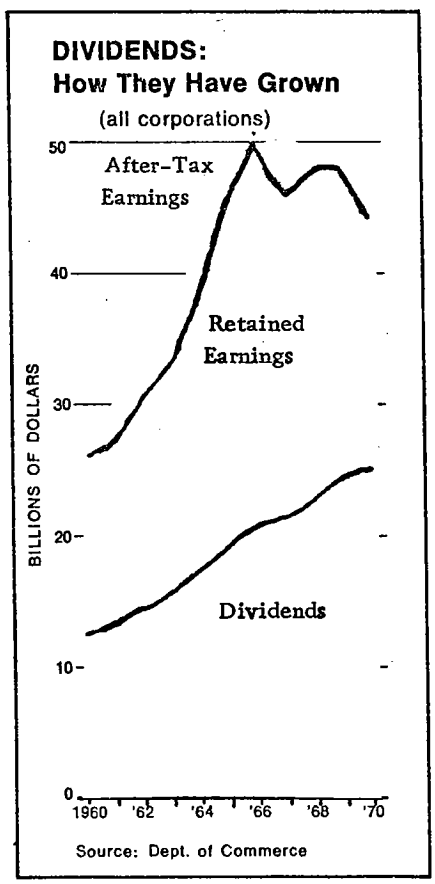
That period of fabulous undervaluation in common stocks gave way to another great primary bull market. The bull market ran the Dow from 161 in 1949 to 995 in 1966. In February, 1966, a primary bear market began. It was during the first massive upward correction of the bear market that the stock-bond ratio flashed its danger signal. A peak of 1.14 was registered on the ratio during the week ending December 23, 1968. This was a few days before the top. During the bear market decline which followed, the ratio headed lower. On the week ending May 25, 1970, the ratio stood at .90.

A second great counter-primary trend advance occurred (and is still in effect). By March, 1971, the ratio had pushed to a record 1.20. Last week (week ending April 19), with stock prices climbing (and stock P/E ratios rising) and with bonds declining (as their yields advanced) the stock-bond ratio lifted to an all-time record high of 1.23. This was well above the 1.14 of December, 1968, and far above the 1.09 of 1929. As measured by the stock-bond ratio, equities as compared with bonds are now at their highest level of overvaluation in history.

DIVIDENDS: I am up-dating the dividend chart (on page 6) which was last published in Letter 483. This is a chart which is based on the monthly tabulations of thousands of corporate dividend statements (statistics are by Standard & Poor). Each month I take the total of dividend increases and resumptions and subtract the total of dividend declines and omissions. This gives me the net improvement or deterioration in that month's total dividend picture.

The March, 1971 statistics show 95 increases and 5 resumptions for a total of 100. They also show 10 decreases and 34 omissions for a total of 44. The difference is 56, which is shown on the chart. This is the same as the 56 of March, 1970 (when the stock market was collapsing), and it suggests little in the way of optimism or profit increases by American corporations. (The 56 figures of March, 1970,and March, 1971, are the lowest March totals since 1961).

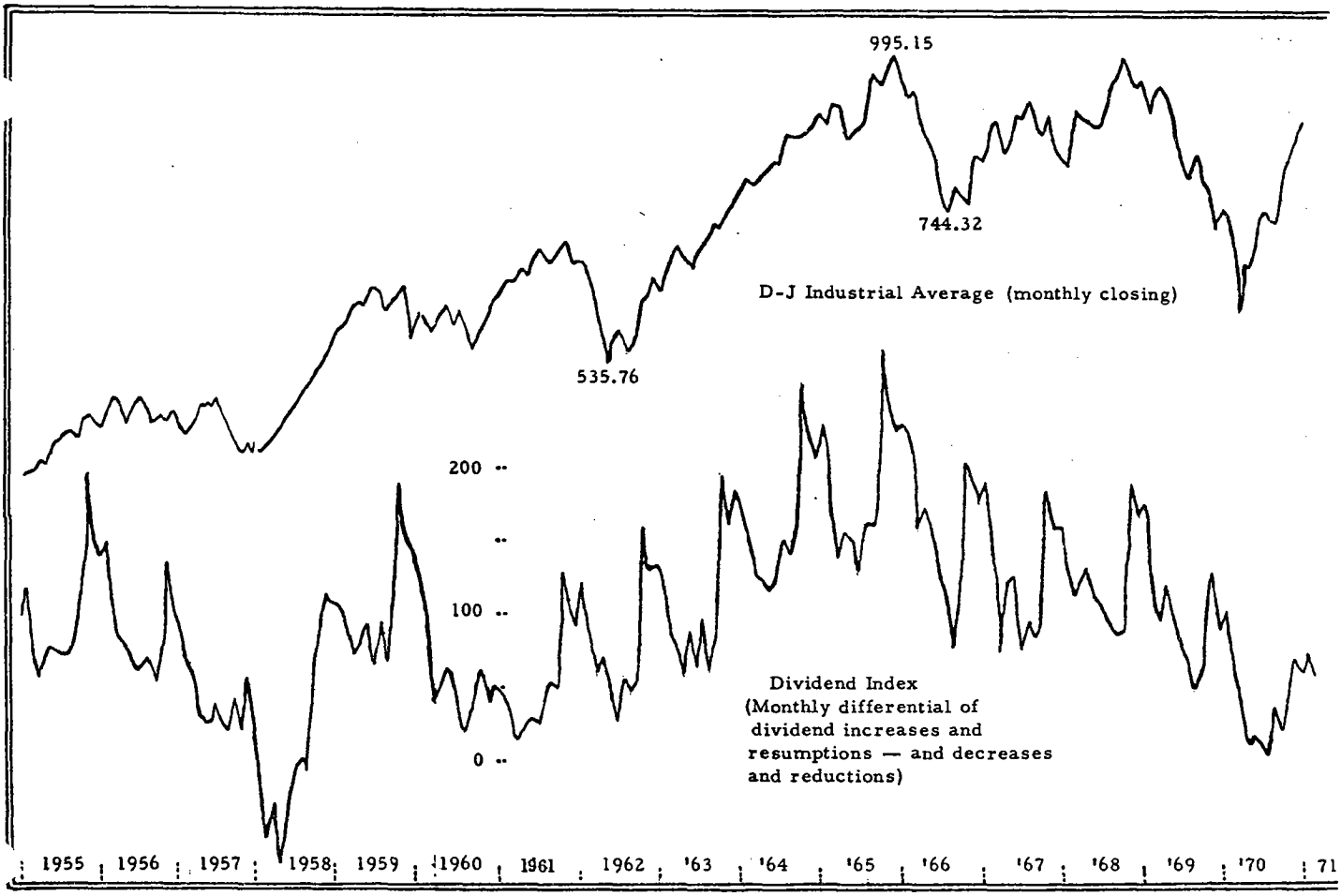
The interesting fact about dividend increases and decreases is that (without all the mouthings and talk) they show what corporations actually feel about the situation currently and ahead. When corporations are flush with cash and see better times ahead, they tend to increase dividends. When they are low on cash and uncertain or worried about the forthcoming picture, they reluctantly lower dividends. So far, this chart shows a continuation of the dividend downtrend which started in mid-1965, half a year before the primary bear market was to begin.



I have included another chart (at right) from Investor magazine, which shows why dividend action has been on the decline. With after-tax earnings in a downtrend and retained earnings being squeezed, corporations have few places to go to boost earnings. One place is costs, which explains a bit about unemployment today. A second place is dividends, and lowering dividends (or payout) helps to retain earnings. As long as retained earnings on this chart are squeezed, we can expect pressure on dividends and dividend declarations. My chart of the trend of dividend increases and reductions will be more sensitive and tend to lead total dividend payouts as shown on the smaller chart.

SNOW JOB: Every effort is being made to blow the statistic up to meet the rationale for the rise in the stock market. My own opinion is that the current much-vaunted rise in business will make for better reading, rather than better profits. The housing industry, which is hoping for 2 million units in 1971, is going full gear into what Eliot Janeway calls the subsidized "junk" or "mini" houses. With the lower mini-house demand on material, Janeway estimates that 2 million houses in '71 would not do much more for the trend than 1.2 or 1.5 million of the old-style, substantial houses.

In autos too, there is the problem of the bargain-minded consumer trading down to the smaller, less profitable and lower material-using models. As the Wall Street Journal recently pointed out (page 1, March 30), the "love affair" between the American consumer and the big, prestige car is over. And it shows in the sales of the smaller, foreign cars and in the sharply rising mix of little cars to big cars in American sales. Ford, particularly, has a problem of "cannibalization", and figures show that since the mini-Pinto's introduction, sales of the larger Maverick's are down 35%.



With corporate capital investment still sluggish, that leaves little in the way of pace-setters to move the economy to anything like boom levels. And the story is revealed in the latest Industrial Production figures for March. In March, Industrial Production edged to an adjusted 165.2, slightly above February's 164.9, but still under January's 165.6.

The big hope is still the consumer, and here too there is a big question as to whether the consumer (frightened by inflation and unemployment) will fill the bill. The latest University of Michigan survey (see chart) shows consumer confidence in February at 78.2, only a few points above the fourth quarter 75.4. The Index, even after this modest recovery, stands no higher than it did at its low point of 1957-58.

I personally have a suspicion that the second quarter of 1971 will be a little better than the first quarter — and that the second quarter will represent the high point for the year. If so, the stock market will be in troubled waters, to put it mildly.